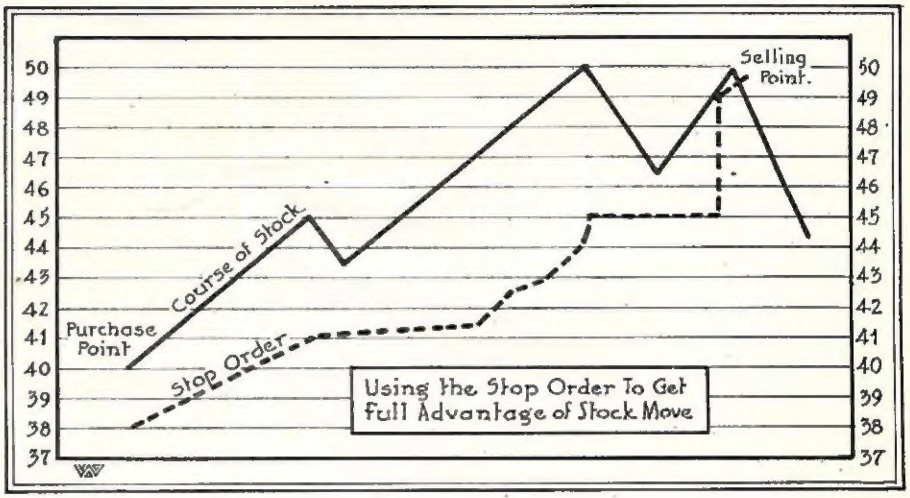
School for Traders & Investors

Fifteenth Lesson

The Use of Stop-Loss Orders

Three Purposes for Which They Are Used—Their Limitations



ONE of our students writes "I am interested in the School for Traders that you are conducting, and wondering when you will take up the question of stop-loss orders or "stops" as they are generally called. I have always thought a stop was the proper thing to use, for although it does not insure you against loss in case the market goes against you, it does limit your loss. Before you buy, you can figure out how much you are willing to risk. However, none of the traders of my acquaintance use them, and, while they are polite enough not to say so, I know they regard me as a species of farmer to want to use a stop. Nevertheless, stops look good to me, and I am interested in having you discuss them."

Our correspondent's observations constitute an appropriate opening for the discussion of stops, and we are glad to take the hint. In the first place, we must compliment him on his clear appreciation of one of the essential principles of successful stock trading, namely, "limit the losses." How many inexperienced traders do the opposite, and "limit their profits" by grabbing a few points in spite of a perfectly well-defined trend in their favor, but hang on grimly to a commitment that is going wrong until the loss is enough to eat up half a dozen moderate profits!

No trader, however big the line of stocks he may be able to swing, can afford to "argue with the market," and he is indulging in this dangerous experiment whenever he refuses to limit his losses. We do not believe that any experienced trader will take issue with us on this point. However, the *best method of limiting losses is another question.* Whether it is better to limit a loss by means of a "stop" or by giving a market order to close out the trade whenever the price reaches a certain "critical point" in a disadvantageous trend, depends on *circumstances surrounding the trade* under consideration. We will review these, and at the same time classify the purpose for which stops may be used to advantage.

A "stop order" is an order instructing a broker to buy or sell a certain stock whenever a round lot of 100 shares of the stock sells at a stipulated price. For example, if U. S. Steel is quoted around par, an order "sell 100 shares U. S. Steel at 98 stop" means that whenever 100 shares or more changes hands at 98, the broker must sell "at the market" the 100 shares involved in the order, and for which he will secure 98 more or less. It may be that only one round lot will sell at 98 on the dip, and, therefore, the stock may rally several points before actually passing 98 on the way down. Nevertheless, the 100 shares involved in our order will be sold at the best price obtainable.

Stop orders are usually given for any one of three purposes, namely,

1. To limit losses,
2. To protect profits,
3. To initiate trades at critical points.

Limiting Losses

To illustrate the first case, we may refer to our definition of the stop order given above. Suppose an odd-lot trader believes that U. S. Steel will advance, and he buys 10 shares at par "with a 2-point stop." As soon as he is long of his 10 shares, automatically his order "sell 10 shares U. S. Steel at 98 stop" is in force. This means that he has taken the position that if U. S. Steel should decline to 98 he will be satisfied that his original estimate of the trend was wrong, and he prefers to accept a 2-point loss rather than remain long of the issue when confidence in the correctness of his judgment has been shaken.

This is a wise safeguard against a larger loss, especially when the trader is unable to watch his commitment from day to day. However, it may be that the stock will hang around par, or a little above, for several days before taking a dive through 98, and during this period while the stock is selling, say, at 101, it may be apparent to a constant observer that the trend has turned and that U. S. Steel should be sold at the market. Hence, the trader "on the job" will close out his long stock around 101 while the occasional observer will have his long stock closed out on stop at 98.

Again, underlying market conditions may be so favorable that a reaction in U. S. Steel to a point a little below 98 should not be construed as a sign of weakness, in fact, it may offer an opportunity to buy rather than an excuse to close out. In this case our constant observer may decide to carry his U. S. Steel purchased at par through the reaction and even buy more in the dip, while our absent trader will have his stock closed out in what may turn out to be the very bottom of the reaction.

In the last two cases cited it is appar-

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NOTICE

Investors and specvestors will find a good deal to interest them in the article entitled "Lame Ducks in the Market and What to Do With Them." This appears on page 1005.

because he usually is well-chosen, is alert for opportunities for improvement and makes a good cooperator with us.

Common errors of arrangement or construction: In this connection, I have noticed that in many of the banks in Chicago the toilets are centralized on one floor. This is done obviously to cut down the cost of supervision and maintenance from the building standpoint; on the other hand, opportunities for loafing are inviting and, naturally, such an arrangement adds to the operating costs of the institution housed in the building.

Another common error is the insufficiency of space assignment, even taking the most modest estimate of what constitutes adequate space.

In bank buildings in general, illumination, ventilation and noise, three of the most important factors in their influence upon output, frequently leave much to be desired.

Also, banks overlook the fact that the biggest item of administrative cost is the payroll and that the problem is to get a good return on that investment in labor. Therefore, it is good policy to make an adequate investment in the capital expenditure intended to produce a good return on the payroll.

One of the important things for a bank to do is develop effective elements of executive control—to functionalize the work. This is now separated into operating departments, but the question of control of these departments is not always easy to define, nor do we always find in banks proper delegation of authorities, responsibilities and duties. This is an organization problem and on its solution is dependent the attainment of satisfactory results from improvement work, whether in the field of office planning or in any other.

HAS THE TIME COME FOR THE AMERICAN BANKER TO HELP FINANCE EUROPE?

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general revival of world commerce is necessary to the development and the restoration and increase of our foreign trade. A lasting revival of world commerce is possible only after an adequate financial reorganization in Europe which in its turn, while it cannot take place without deep-cutting internal reforms, and while it must start from within, cannot be successfully accomplished without our active support, material and moral.

This support given, not only for the general good but just as much for the sake of our own individual self-interest, should be expressed by broad policies in regard to investment, immigration and tariff, facilitating and not obstructing the international flow of capital, labor, and goods. **Only by helping at the proper moment to reconstruct the shattered nations of Europe and to create markets in the younger and still less developed countries of South America and the Far East, can we hope to gain the today useful, tomorrow perhaps necessary, permanent foreign outlets for our American trade, and only by the closest welding of our financial with our industrial and agricultural power and its effective combined use abroad can we hope to counteract the advantages which in certain respects some of our older competitors have over us in the imminent struggle for world trade.**

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ent that the absent trader with his stop-loss order is at a disadvantage compared with the constant observer who is trading without stops and depending on market orders. This illustrates what we mean by the "circumstances surrounding the trade" mentioned hereinabove.

This is not an argument against the *principle* of the stop-loss order by any means, for our constant observer, if he is wise, is carrying what we may term a "mental stop," even if he does not place a stop-loss order "on the floor." At the first convincing sign of weakness he will close out his trade, and if his idea of weakness is the fact that the stock has descended to a certain price level which he considers "critical" he will be virtually executing his "mental stop" by closing out his trade. Therefore, the principle of the stop as a means of limiting losses remains unassailable.

Protecting Profits

Traders who desire to insure against the loss of profits already secured "on paper" but not yet taken, especially in issues that have advanced rapidly and may at any time develop technical weakness, often use stops to accomplish this purpose. For example, suppose our trader purchased BALDWIN at 115 and then watched it climb to above 125. He might reason, "I have 10 points paper profit, but I think the stock will go higher. I am willing to ride through a 4-point reaction, but I am determined not to lose all my profit in a sudden decline which may take place when I am not in a position to watch the market. Therefore, I will place a stop at 120⅞ so as to secure about 5½ points less commissions, no matter what happens."

This is a reasonable view of the situation, and the principle involved may be applied further by raising the stop if the price of the stock advances. Thus the stop serves a purpose in trading that is somewhat analogous to one of the offices of a ratchet in mechanics, that is to say, it allows profits to increase so long as they will, but it will prevent them from shrinking below a certain limit.

Opening Trades With Stops

Stops are sometimes used to open trades, especially when the trader has made up his mind that whenever a certain stock, which has apparently been under accumulation for several weeks, advances above a certain price, it is likely to be entering the "marking-up-stage" of its speculative cycle, and thereafter ad-

vance rapidly. For example, suppose the issue in question, after a long decline to around 20, begins to move up and down in a narrow range, say between 20 and 23, and without breaking below 20 for several weeks. Our trader may reason "this stock acts as if it had met support around 20, and its behavior suggests that all shares offered between 20 and 23 are being gradually absorbed by those who think it is a bargain within this range. I will not buy the stock now because the period of accumulation may continue for several months before the time is ripe for the successful manipulation of the advance which is apparently under consideration for some future date, and I will have to carry the stock through such a period with loss of interest and with my money tied up in a 'sleeping' issue. However, I want to buy some of the stock when the big move starts, and this will probably be nearly whenever the supply is reduced to a point where the bids will have to be raised to 24 or 25 in order to get any of it. Hence, I will place my order now as follows: 'buy at 25 stop, G. T. C.,' which means 'buy as soon as a round lot of 100 shares changes hands at 25; this order to remain in force until countermanded.'" By this use of the stop, our trader will not have to watch the issue under consideration from day to day for perhaps several weeks, but he will automatically "be placed aboard the train when it starts" assuming, of course, that his judgment of the case is correct.

Limitations of the Stop

It will be apparent to the experienced trader that the above mentioned uses of stops can be applied successfully only to active stocks, with a reasonably close market and where the lots traded in are of moderate size. For example, the method will work perfectly with, say, 100 shares of U. S. Steel, which changes hands in considerable volume during any normal market session, and usually moves not more than ⅛ to ¼ point between sales. On the other hand, it would be ridiculous to attempt the use of stops on a commitment involving 1,000 shares of any issue that jumps 5 or 6 points between sales, and usually appears once or twice a week, and then only in volume aggregating 200 or 300 shares. In other words, stops are not advisable in trading inactive or thin-market issues.

Sometimes the question is asked: "How far away shall I place my stop?" The answer depends on the characteristics of the issue in question, and the state of the general market. For example, in active, close-market issues, a stop may be placed 3 points or closer to the commitment price. At certain times an active stock may be bought or sold with a one-point stop with confidence. Under ordinary trading conditions a 3-point stop is common on active issues, perhaps on the theory that if an issue moves as much as three points in a certain direction, it is acting under influences sufficiently important to make it move further in the same direction. This is by no means a law, but has been found probable in numerous cases.

Trades in thin-market issues should not be protected by 3-point stops, as such

issues sometimes move 3 points or more between sales, and if enough stop orders exist at one time on the floor, both specialists and floor traders may be tempted to "gather in the stops" if it should appear advantageous to do so. Where a 3-point stop is not wide enough, sometimes a 5-point stop will fall outside the probable limit of normal reaction, but when even this is not wide enough it is highly probable that the stock under consideration is unfit for trading operations, or commitments therein should be protected only by "mental stops."

The foregoing observations are worded to apply to the long side of the market, but it is apparent that exactly the same reasoning applies to the short side. In fact, stops are more important on well-margined short trades than on long trades, especially in higher-grade issues which have investment qualities. If a trader becomes sewed-up with a large paper loss in a sound issue which he has purchased, and can afford to assume the rôle of an "involuntary investor" for the duration of the major cycle depression which may have overtaken him, he may eventually emerge without loss, and even with profit, but if he is short without stop-loss protection, and the issue happens to become a speculative football even for a brief period, he runs the risk of serious embarrassment, perhaps even worse than that of the man who allows his fire insurance to lapse just before the house catches fire.

If any of our readers have had interesting experiences owing to the use of stops, or the failure to use them, we shall be glad to hear their testimony.

How to Use Stops to Increase Profits

Although the stop order is used most frequently for the purpose of limiting trading losses, it has numerous other uses that are advantageous not only to traders but also to investors for the long pull.

For example, the trader who purchases an active stock at an advantageous price, following a reaction in a bull market, may first place his stop to limit his loss in the event of sudden reversal of trend; and then raise it as the stock advances in price, with a view to keeping it far enough below the market so as to avoid being stopped out by normal minor reactions, but at the same time close enough to stop the trade in the event of a reaction sufficient to confirm the development of technical weakness in the issue under consideration.

The object of this maneuver is to allow paper profits to increase as far as the minor swing will permit, and to secure a considerable percentage of these paper profits before they are wiped out by the substantial reaction that is almost sure to follow sufficient temporary distribution of the stock. Of course, if the trader is convinced that the issue is under such distribution, and it fails to make further headway, he may close out his trade without waiting to be stopped out, but if he cannot be in constant touch with the market, the scheme of moving up the stop as suggested will insure a definite proportion of the paper profits.

Suppose the purchaser of the stock under consideration has made his commitment towards the close of a major de-

pression, that he is not interested in trying to take advantage of minor swings of the market, and desires to hold his stock with the intention of disposing of it during a boom period. In this case he will take advantage of the first substantial advance to raise his stop sufficiently to cover cost and commissions, but thereafter he will not try to secure a large percentage of the first minor swing upward. On the other hand, although he may raise his stop from time to time, he will aim it well below the zone of market activity of the stock, until the time arrives when market inflation is apparent and the stock in question gives evidence of distribution on a broad scale. Then, and not until then, he will assume the position of the short-swing trader, and raise his stop to a level through which a reaction in his pet issue would indicate definite and serious weakness incident to the beginning of liquidation.

Here we have two distinct uses of the stop for the purpose of allowing profits to increase. The active trader who desires to follow persistently one or more standard issues throughout an entire bull market may combine the two positions above outlined by repeatedly repurchasing his stock, whenever it has completed its reaction following its passage through his profit-protecting stop, and when it offers evidence of re-accumulation for another minor upward swing. Thus, the trader who operates repeatedly in the same stock, virtually maintains a long-pull position, and by side-stepping a fair portion of each substantial reaction, he is from time to time *marking down the original cost* of his stock, and thereby increasing his total profit on the issue for the duration of the bull market.

The reasoning involved in the above discussion applies correspondingly to the major decline, but with conditions reversed, and with due regard for the extra precautions to be observed when the market is highly manipulated during the period preceding the heavy wave of liquidation that frequently introduces the bear market.

Securities Analyzed in This Issue